IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 22143

PENNALUNA AND COMPANY, INC., BENJAMIN A. HARRISON AND HARRY F. MAGNUSON, *Petitioners,*

v.

SECURITIES AND EXCHANGE COMMISSION, *Respondent.*

On Petition To Review an Order of the Securities and Exchange Commission

PETITION FOR REHEARING

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PETITION FOR REHEARING

Pennaluna and Company, Inc. (Pennaluna), Benjamin A. Harrison (Harrison) and Harry F. Magnuson (Magnuson), Petitioners herein, respectfully petition for rehearing (with reargument), reconsideration and affirmance, in part, and reversal, in part, of the Court's decision of April 10, 1969. We are appreciative of the care and attention which this Court has given to Petitioners' cause, as witnessed by the well prepared and active participation of

the Court at Oral Argument, the time which the Court retained the case for deliberation, as well as the opinion itself. We nevertheless earnestly submit that the sound administration of the Securities Act, as well as simple justice dictate the grant of this petition for rehearing.

Without waiving our other contentions, this petition is addressed mainly to the issues of the Burden of Proof, the question of Magnuson's control of Silver Buckle and the question of the propriety of the penalties imposed. We respectfully submit that the court has erred in its holding that Commission was correct in imposing upon Petitioners the burden of establishing a lack of Control by Magnuson and in holding that Magnuson in fact was in Control of Silver Buckle.

The Court recognizes that: "While the Congressional Concern reached to all secondary distributions of significant proportions it was obvious that it could not impose upon a seller other than the issuing corporation the duty of registering his stock unless the shareholder was in a position to require the issuing Corporation to seek registration" (slip 5).

The standard established is clear: "Is a particular person in a position to obtain the required signatures of the issuer and its officers and directors on a registration statement?" (slip 5).

We earnestly submit that the Court errs in imposing on the seller in a secondary offering the burden of establishing his inability to secure the necessary corporate action.

How is such burden to be sustained? Indeed how does one prove a negative? In the instant proceeding the Commission and, apparently, this Court have ignored the uncontroverted testimony of Dr. Scott, Silver Buckle's President and the individual who was exercising managerial control over the corporation, that control of the Corporation rested in Scott, Gay, Hull and Crammer. The Court

itself recognizes that these individuals were "unquestionably in control of Silver Buckle."

The Court relies on *SEC* v. *Franklin Atlas Corp.*, 154 F. Supp. 395 (SDNY, 1957), but the result in that proceeding on the actionable facts there involved dictates a reversal of the Commission's ruling in the instant proceeding. As to *SEC* v. *Culpepper*, 270 F. 2d 241 (2nd Cir., 1959) we can only suggest that the factual pattern there is the direct opposite of the instant case. There the defendant, Culpepper, had been in unquestioned control of the corporation, and had only recently resigned as its President, continued as a consultant and was one of its largest stockholders at the time of the sales in question.

It is apparent that the Court's language in both cases was merely judicial shorthand descriptive of the patently evident action of the defendants in devising a fraudulent scheme to evade the Statute. In each case, the Court first found clear Prima Facie cases of the exercise of statutory Control, as well as Prima Facie cases of statutory violations. The so-called Burden of Proof argument in each case in reality merely noted the absence of any real defense to the facts establishing the exercise of Control. Further, the remedy which the Commission sought to achieve was merely to enjoin future violations—not to debar the individuals permanently from their means of livelihood.

We have no dispute with the proposition that in a primary distribution where the shares come from the issuing company, there is a presumptive need for registration. It is a sound, practical requirement that in such circumstances, one who claims an exemption from the registration requirements of section 5 has the burden of proving the exemption applies. *SEC* v. *Ralston Purina Co.*, 346 U.S. 119 (1953); *SEC* v. *Sunbeam Gold Mines Co.*, 95 F. 2d 699 (9th Cir., 1938). We submit that to apply the presumptive test to secondary distributions, without resort to the

rule making processes of the Commission with its attendant notice, hearing and future application concepts, is a violation of Petitioners' rights to administrative due process.

The results of the instant case are illustrative, and the *Culpepper* and *Franklin Atlas* cases relied on by the court stand in sharp contrast.

Here, the Commission imposed a burden—you are presumed to be in control of Silver Buckle until you prove otherwise. From that presumption flowed its finding of control, its conclusion of violations of the Act, which, in turn, supported the finding of fraud which justified its permanent debarment of the individuals.

The Court should note that the *Culpepper* and *Franklin Atlas* cases banned future conduct with respect to the stock in question. Here, the Commission on the strength of such presumptions, seeks permanently to debar the Petitioners from the right to earn a livelihood. This presumption of illegal conduct is without parallel in the law and should not itself be presumed in the absence of clear Congressional intent. Indeed, while the concept of the burden of proof is an oft-quoted concept, every case examined by counsel herein shows clearly that in each such case the court found clear evidence of specific acts of the exercise of control by the individuals concerned, or specifically found the individuals concerned to have acted as agents for those in control. There is no such finding in the instant case. But, even if the burden lies with Petitioners, Petitioner Magnuson clearly has met that burden.

MAGNUSON'S CONTROL OF SILVER BUCKLE

This Court has rightfully held that the intent of Congress was not to impose a duty of registration upon persons who were not in a position "to *require* the issuing Corporation to seek registration" (slip P 5, italic added) and that to require registration by a particular person, he

"must be in a position to obtain the required signatures of the issuer and its officers and directors on a registration statement." (slip P 5). We concede that "Control is not determined by artificial tests—but from the particular circumstances of the case; that, arguendo, it is not necessary for one to be an officer, director or manager or even a shareholder to be a controlling person; and, that control may exist although not continuously and actively exercised. (slip P 6)

It is recognized that the question of what constitutes "Control" is one for initial determination by the Commission and that the Commission's findings should not be overruled so long as there is warrant in the record for the judgment of the expert body.[1] We do not dispute that Magnuson ultimately came into control of the Company. The Question which was before the Commission and is now before the Court is—When. The Commission resolves the question by finding he was in control from his first contact with the Company in May, 1962. We submit that holding contravenes all prior precedent of the Commission and the Courts and is wholly without evidentiary support in the record. Indeed it is directly contrary to record evidence. Since the Commission has not otherwise established the date of control, we submit this Court must reverse its finding that Magnuson was "in control" of the Corporation at the time of the Purchase and Sales Complained of.

We recognize that the question of Who is in Control of a Corporation is a question of fact for determination by the Jury or the Commission as the case may be.[2] Indeed Commission Policy will not permit its lawyers to express opinions as to the existence or nonexistence of control

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[1] Rochester Tel. Corp. v. U.S., 307 U.S. 125, 146, 83 L. Ed. 1147, 1161, 59 S. Ct. 754.

[2] See Stadia Oil and Uranium Co. v. Wheelis, 251 F. 2d 269; Wilko v. Swan, 127 F. Supp. 55; Archer v. SEC, 133 F. 2d 795, 799.

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except in the clearest cases.[3] But, the history of our jurisprudence demands some evidence to support the finding of the fact finding body.

What standards support the finding of a Control relationship? This court has accepted the concept of the ability of the individual to obtain the requisite signatures on the Registration Form. How is this demonstrated? We have researched the Commission's opinions, orders and material. We find no provision whereby an individual can force a company to effect registration. Indeed in an unrelated matter we have been advised that an individual could not intervene to force registration of his stock when the Company seeks to register a special block of stock. And in the absence of contractual obligation, we find no judicial precedent for requiring a Corporation to effect registration of its stock.

We have researched contemporaneous statutes using the concept of Control. In the *Allegheny Corp.* v. *Breswick & Co.*, interpreting the use of the word "control" in section 5 of the Interstate Commerce Act[4] the Court there held:

> "The crux of each inquiry to determine whether there has been an 'acquisition of control is the nature of the change in relations between the Companies whose proposed transaction is before the Commission for approval. Does the transaction accomplish a significant increase in the power of one over the other, for example, an increased voice in management or operation, or the ability to accomplish financial transactions or operational changes with greater legal ease'?"[5]

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[3] Gadsby, Business Organization, Vol. IIA. See 3.02(2), citing Loss, Security Regulation, Vol. II, p. 782. Edmund Gadsby is Former Chairman of SEC.

[4] 54 Stat. 899, 905, 49 USC § 5(2)(Q).

[5] Allegheny Corp. v. Breswick and Co., 353 U.S. 151, 169, 1 L. Ed. 2d 726, 739, 77 S. Ct. 763.

There is no evidence that Magnuson realized any such change vis-a-vis Silver Buckle during the period of May 1962, or through January 1963.

In *Detroit Edison Co.* v. *Securities and Exchange Commission,* the Sixth Circuit, interpreting the concept of Control as used in the Public Utility Holding Company Act,[6] after reviewing the extensive evidence of interlocking relationships, held:

> "The types of control referred to are: (1) through complete ownership of capital stock, (2) a majority ownership, (3) through a legal device without majority ownership such as pyramiding through holding companies or a large issue of non-voting stock with a comparatively small issue of stock with voting rights, or voting trust, (4) Minority control, which exists when comparatively few shares of Corporate stock are in the hands of one group and the remainder widely scattered, (5) Managerial Control, which exists where all the stock is so widely distributed that no stockholder takes sufficient interest in the affairs of the Corporation to influence or control it, (6) Proxy Control through Committees, (7) through interlocking Corporate Officers or directors."[7]

There is no evidence that Magnuson could assert any such powers over Silver Buckle during the period from May 1962, through January 1963.

The most relaxed concept of "Control" our research has established is applied in determining whether an account is subject to the control of a brokerage firm for purposes of determining a finding of "Churning". Even there, it is held that the evidence must establish that the customer *invariably* relied on the dealers' recommendations.[8] There

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[6] The Public Utility Holding Company Act of 1935, 49 Stat. 834, 15 USCA, § 79x.

[7] Detroit Edison Co. v. Securities and Exchange Commission, 119 F. 2d 730, 739.

[8] *Hecht* v. *Harris, Upham and Co.,* 283 F. Supp. 417, 433.

is no evidence that, during the period of May 1962 through January 1963, Silver Buckle invariably relied upon—or even sought—Magnuson's advice on anything. All they sought—or received—was assistance in locating someone to buy the shares in question.

Unfortunately the cases wherein no control is found are not generally reported. A few such cases are available. In *Wilko* v. *Swan,* the Corporate Counsel who was also a member of its Board of Directors was found not to be "in Control of" Air Associates, the Company in question.[9] In *U. S.* v. *Sherwood*, an individual dominating 8% of the stock, not a member of the Board of Directors, was found not to be a control person.[10]

Finally, in *Winter* v. *D.J.&M. Investment and Construction Co.,* the Court held:

> "Ross had no connection with the issuer and the only evidence which might possibly indicate a control relationship existing between Usedco and D.J.&M. is that Cravitz, the defendant, was an attorney for both Corporations.
>
> "The evidence is quite clear that the sale * * * was made by Ross as principal and not as an agent for D.J.&M. * * *
>
> "Each step in these transactions regressing from the sale to the plaintiff makes the possibility of finding of control more remote. The Control must be a Control by the defendant involved of the defendant found liable, i.e. Ross. As to Rothbord and Tells, it does not appear that they were at all acquainted with Ross. D.J.&M. was but one of the sources from which Ross obtained the Usedco stock he was selling to the public. There is no evidence upon which to base a finding that D.J.&M. controlled Ross.

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9 *Wilko* v. *Swan, supra*, footnote 2, see also 346 U.S. 427, 429, 98 L. ed. 168, 172, 74 S. Ct. 182.

10 *U.S.* v. *Sherwood*, 175 F. Supp. 480, 483. The Court will note that Chief Judge Sugarman there held that there is no authority for holding that shares once owned by "Control" persons retain "control" characteristics in the hands of subsequent owners.

> "There are suspicious circumstances from which one gains the impression that there have been shady goings-on, but the defendants cannot be held liable on suspicion." [11]

We submit, however that the Commission wholly failed to find or establish a single indicia of the exercise of Control of Silver Buckle by Magnuson during the relevant period—other than the purchase and sales complained of. There is no indication he held any office, made any decisions, managerial, investment, or even janitorial relevant to the corporation. He guaranteed no loans, advanced no money, did not act as a consultant, or in any other way act for the corporation, direct the acts of others on behalf of the corporation, or hold himself out as having any authority to act for the corporation or to cause or influence its decisions. Further, there is no evidence that during the relevant period, Magnuson benefited directly or indirectly from the acts of the corporation. Finally, there is no showing that his service on subsidiaries in any way influenced the activities of Silver Buckle, or was motivated by anything other than his personal investment in these subsidiaries.

We submit that if the purchase and sale of stock be an indicia of Control the opinion herein will create control situations affecting countless investment bankers, broker-dealers and others. The detrimental effect of such a holding on the financial community at large should not be ignored.

We further submit that the Commission and the Court have ignored the relevant facts of record. Indeed the Court finds that Scott, Gay, Hull and Crammer were included in "those unquestionably in Control of Silver Buckle". The Court should note that the only evidence in

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[11] Winter v. D. J. & M. Investment & Construction Corp., 185 F. Supp. 943.

the record bearing on the question of control are the depositions of Scott, Magnuson, Gay and Hull. Magnuson denies being in control, and Scott, Gay and Hull identify themselves as the controlling persons. Dr. Scott's testimony on the subject is unrefuted and uncontested. And Dr. Scott did *not* include Magnuson as a person in Control (Tr. 2050-2051). What the Commission ignored in reviewing Magnuson's so-called "prior relationship with those individuals who clearly constituted the Silver Buckle Control Group," was that Wallace, Idaho, is a community of some 3000 persons. Magnuson is a leading Certified Public Accountant there; Hull, one of its leading attorneys; and, Pennaluna, one of its few broker-dealers.

For those "who clearly constituted the Silver Buckle Control Group" to turn to them and Pennaluna for assistance is wholly understandable, and surely not sinister. It hardly constitutes evidence of any quality that Magnuson was thereby placed in a "position to *require* the issuing Corporation to seek registration" or "to *obtain* the required signatures of the issuer and its officers and directors on a registration statement". By what color of Authority or Persuasion was Magnuson "to require" or "to obtain" the requisite signatures? We most earnestly suggest to this Court that the Commission has built its case on shadow, innuendo, presumption and hindsight. Surely this is not the quality of evidence upon which an individual can be permanently deprived of the right to pursue his profession.

We are not here talking of an action to enjoin future conduct—in such instance the exigencies of protecting the public interest may well dictate restraining the individual rights and preserving the status quo. Here the Commission seeks, permanently, to debar the individuals from their profession by virtue of past conduct—without ever proving the essential requisite to establish such conduct as violative of the Statute. We submit that application of the presumption of control in these circumstances deprives the Peti-

tioner of his Constitutional rights to administrative due process.

We shall not burden the record by mere restatement of arguments previously made. We here incorporate by reference, Petitioner Magnuson's Reply Brief on the Petition for review, and adopt same for all Petitioners on Rehearing.

We submit that the Violations by both Magnuson and Harrison, as well as the Antifraud Violations and the Bids and Purchases of Stock during distribution are not supported by substantial facts of record. With respect to Attorney Hull's letter of Oct. 5, 1962, we respectfully invite the Court's attention to the fact that the "relevant facts" not discussed in the letter were fully known to the Attorney—as witness his close relationship to both Magnuson and the Control Group. We must then presume that they were given due professional weight in reaching his decision that Magnuson was not in Control.

As to the conduct of the SEC staff, we pray the court to recognize that these were by no means an afterthought. They may well represent the truly shocked reaction of new counsel on hearing of the staff's conduct and whose entry into the case came after expiration of the rehearing time before the Commission. We respectfully urge the court to find that such conduct which is unbecoming a government agency is per se prejudicial. As to the specificity, we have prayed for a hearing on the subject to bring to the Commission's attention the specific instances complained of. This we were denied, but we still feel the Commission is the proper forum in which to air such complaints. We urge the court to direct the Commission to entertain that petition.

CONCLUSION

For the foregoing reasons, we respectfully submit that a rehearing, en banc with reargument should be ordered in this case.

Respectfully submitted,

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